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TAGS: [ECON](#) [EFIN](#) [EAID](#) [PGOV](#) [PREL](#) [MK](#)
SUBJECT: MACEDONIA: CAN THE DENAR AVOID DEVALUATION?

REF: SKOPJE 0052

Classified By: DCM Tom Navratil for reasons 1.4 (b) and (d)

¶1. (SBU) Summary. Macedonia's current account deficit widened dramatically in 2008. The central bank's currency reserves have dropped at an alarming rate in 2009, raising concern about the country's ability to maintain the pegged value of the denar at roughly 61 to the euro, a fundamental element of the country's economic policy. Some businesspeople are concerned that a devaluation of the denar may occur in the late summer or fall as a result. The official response, however, is split: While the National Bank of the Republic of Macedonia (NBRM) is taking steps to tighten monetary policy in defense of the peg, the GoM has advocated a looser fiscal policy, including deficit spending. It is unclear if the center can hold. End summary.

¶2. (SBU) Macedonia's small economy is heavily reliant on imports. The country's trade deficit grew from about 23 percent of GDP in 2007 to 33 percent of GDP in 2008. Statistics from the first two months of 2009 indicate that the trade deficit will grow further as imports continue to increase and demand for Macedonia's exports declines as a result of the global economic slowdown. The dramatic increase in imports in 2008 was a result of the rise of the cost of imported fuel (44.8 percent increase in 2008 compared to 2007) and the increasing ease with which households were able to obtain credit for purchases such as automobiles. In fact, NBRM Governor Petar Goshev told the Ambassador, the value of imports to the country now doubled that of exports. Macedonia's largest export sector, metals, has been hit particularly hard by lack of demand. While overall industrial production dropped in January 2009 by 16.7 percent from January 2008, metals production in January 2009 plunged by 76.6 percent compared to the previous year. As a result of this and other pressures, the current account deficit rose to an estimated 14 percent of GDP in 2008.

¶3. (SBU) Until the fourth quarter of 2008, foreign direct investments brought significant funds into Macedonia, easing the current account deficit and spurring growth. However, much of these inputs were themselves used to import equipment and raw materials, dampening the effect on the overall current account deficit. By October 2008, however, foreign investors began to postpone or cancel planned investments. The latest postponement came from the Turkish firm TAV Airports Holding, the chosen concessionaire for the upgrade and operation of two existing airports in Skopje and Ohrid, and for building a new cargo airport in Stip. TAV's estimated USD 260 million investment has been postponed to a later, undetermined date. Finally, estimates for net private transfers to Macedonia dropped from 18 percent of GDP to 15 percent of GDP in 2008, according to IMF statistics.

¶4. (SBU) At the same time, the GoM has set itself on a course for increased spending. The government has ignored IMF's advice to save money for more difficult times, and spent wildly in December 2008. The GoM's budget for 2009 aims for a budget deficit of 2.8 percent of GDP, while optimistically projecting GDP growth of 5.5 percent. See

reftel. However, on March 5, Minister of Finance Trajko Slaveski announced that budget revenues in the first two months of 2009 were 3 percent lower than in the same period of last year, and were below GoM projections. (Note: Many of our interlocutors expect the GoM to revise the budget after the April 5 second round of presidential and municipal elections to account for reduced revenues. However, there is no indication that the GoM would restrain its own spending, as budget projections for 2010 and leading party campaign slogans call for increased deficit spending. End Note.)

15. (C) To pay for the growing current account deficit, the NBRM has been spending currency reserves at an alarming rate. Valued at USD 2.4 billion in September 2008, the country's reserves were worth about USD 1.8 billion in early March, and are being spent at an average rate of about USD 65 million a month. On February 26, the NBRM issued a press release claiming that additional denar purchases were not needed to support the peg. However, on March 5 NBRM Governor Petar Goshev told the Ambassador that foreign currency inflows were desperately needed as reserves were quickly being spent. In fact, Goshev said that during the first four days of March, the NBRM had spent more than USD 25 million to maintain the peg. Goshev said that he suggested to Prime Minister Gruevski a prompt budget rebalancing to direct more funds to promote exports, and taking an IMF loan of about USD 390-650 million for direct balance of payments support. Neither of the two suggestions, the Governor said, were acceptable to the PM, because the proposals would "hurt the government's reputation." Instead, PM Gruevski has pressured Goshev to state publicly that under no circumstances will there be a currency devaluation. Goshev so far has resisted doing so, concerned that he would be blamed if the peg becomes unsustainable. Goshev assured the Ambassador that the NBRM would continue to intervene to maintain confidence in the currency as needed, defending it "to the last breath." Separately, IMF representatives told us they believed that a ten percent drop in the currency's value would be likely if it were allowed to float against the euro. IMF also said their message to the PM is that sustaining the peg requires fiscal discipline as well as proper monetary policy.

16. (SBU) In the business community, however, confidence appears to be vulnerable. In recent weeks we have heard repeated concern for the denar's stability, even before the story was picked up by the press late February. Skopje's licensed Coca Cola bottler and brewer of the popular "Skopsko" beer, for instance, estimated that some 60 percent of the company's inputs were imports purchased with euros. Against that, 100 percent of the company's income was denominated in denars. Similar concerns have been voiced by AmCham members from across several industries at recent events, and many Macedonians are concerned that car and other personal property loans denominated in euro could become unmanageable if the current exchange rate were not maintained. Bank customers have increasingly sought to convert their denar deposits into foreign currency, mainly euro, reversing a trend toward holding deposits in denars. Companies were concerned that customers were paying in denars, while commercial loans and raw materials were denominated in euro. That said, the GoM and many importers are actively pressuring the Governor of the NBRM to change its policy and lower the interest rate, to stimulate spending and make credit less expensive for customers.

17. (C) Comment. We believe Goshev when he says he will defend the denar as long as he can. However, GoM policy and the country's dependence on imports are working against him. The GoM takes issue with Goshev's recommendation to slow credit growth to reduce imports and his recommendation to take an IMF loan, preferring instead to argue for more stimulus spending. The GoM has several policy options open to it. Most likely is a recalculation of the budget adjusting spending downward, a tactic that has been used by the GoM several times in recent years. Less likely but not out of the question would be a GoM adoption of a loan from the IMF. In any case, the GoM is unlikely to take any serious action on balance of payments issues before the April

second round elections.

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